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Internal Revenue Service
memorandum

CC:TL-N-246-91
Br1:JAWright

date: DEC - 3 1990

to: District Counsel, Cleveland CC:CLE
Attn: RWKERN

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Sale/Leaseback-[redacted]

This is in response to your request for tax litigation advice received by this Branch on October 10, 1990, regarding the propriety of recharacterizing [redacted]'s sale and subsequent leaseback of the [redacted] ([redacted]) generating plant as a financing arrangement and the hazards of litigating such action.

ISSUE

Whether the [redacted]'s sale and subsequent leaseback of the [redacted] ([redacted]) generating plant can be successfully challenged as a financing arrangement. 0163-0600; 0167-1400; 0167-1500; 0167-2300; 0168-0502.

CONCLUSION

In light of the present case law in this area, we believe that the present transaction can not be successfully challenged as a financing arrangement. The present transaction has economic substance and the possibility of substantial appreciation and cash flow inuring to the benefit of the lessors/investors indicates that the lessors/investors have sufficient benefits and burdens of ownership to withstand a challenge to the structure of the transaction.

By memorandum dated August 29, 1990, the Assistant Chief Counsel, Income Tax and Accounting addressed your initial question of whether the Service is precluded from recasting a sale-leaseback transaction as a financing arrangement if the taxpayer ostensibly meets the requirements enumerated in Revenue Procedures 75-21, 1975-1 C.B. 715; 75-28, 1975-1 C.B. 752; and 76-30, 1976-2 C.B. 647. In summary, you were informed that these revenue procedures merely contain guidelines for obtaining an advance letter ruling as to whether a transaction is in fact a lease for Federal income tax purposes. Thus, these revenue procedures do not preclude the Service from challenging the form of this transaction despite its compliance with them.

We believe that the examiners and the ISP Utility Staff should be commended for their efforts in identifying and pursuing this issue in the context of Nuclear Generating Facilities. The ISP Utility Staff conservatively estimates that $[redacted] in assets are involved in these types of transactions in the electric utility industry occurring during the years [redacted] through [redacted], thus the potential for abuse is enormous. However, for the reasons set forth in the body of this memorandum, we do not believe that the Service will prevail against [redacted] in recharacterizing the sale/lease back transaction as merely a financing arrangement.

FACTS

By agreement dated [redacted], [redacted] ("lessee") entered into the sale and leaseback of its [redacted] percent undivided interest in the nuclear powered electric generating unit known as [redacted] ([redacted]). [redacted] institutional equity investors ("lessors/investors") collectively purchased this interest for an aggregate sales price of $[redacted]. This was the fair market value of the property as appraised by [redacted] business consulting company. The investors made an equity investment of at least [redacted] percent of the sales price and leveraged the balances.

The transaction was arranged by and accomplished with the involvement of the [redacted] ([redacted]) who entered into grantor trust agreements with each of the investors. As owner trustee for the investors, [redacted] executed non-recourse lessor notes for the financed portion of the sales price. Pursuant to the trust agreements, the investors, as beneficiaries of the trusts, are entitled to all the tax benefits inuring to the trust on the entire cost of the facility.

To provide financing for the transaction, [redacted] ([redacted]) was formed. This corporation, ostensibly unaffiliated with any of the parties to the sale-leaseback, issued collateralized lease bonds in an amount approximating the amount of the original lessor notes. The lessor notes were executed and issued to the [redacted]. The non-recourse lessor notes are the same as the bonds in respect of amount, interest rate, and maturity. Accordingly, the [redacted] will have no income or loss because its interest income from lessor notes will always equal the interest expense on the lease bonds. The expenses of the bond registrations and insurance were borne by [redacted]. The lessor notes issued to the [redacted] are secured by the lessor's rights under the lease and are without recourse to the investors or [redacted], the owner trustee. The [redacted]'s bond debt service is paid from the lease payments that [redacted] is unconditionally obligated to pay. The transaction requires that the lease payments at all times be sufficient to pay the interest and principal on the lessor notes and thus the lease bonds. Any payment in excess of debt service is disbursed to the lessors and pays interest to the bondholders.

Only [redacted]'s [redacted] percent interest in [redacted] is subject to the sale-leaseback transaction. A separate lease agreement was entered into with each investor even though the leases are very similar. The term of the leases to [redacted] is for approximately [redacted] years, beginning [redacted] to [redacted]. An option exists for [redacted] to renew the leases for an additional [redacted] year period. The estimated useful life of [redacted] is [redacted] years. The leases call for semi-annual rent payment to be paid by [redacted]. The payment dates coincide with the dates on which interest payments are due on the collateralized lease bonds ([redacted] and [redacted] of each year). At a minimum, all leases require that the semi-annual payments be sufficient to pay the principal and interest on the bonds. Any rent in excess of this amount is distributed to the investors as return on their investment. The investors receive also the tax benefits of owning the property, i.e., depreciation and interest expense.

The lease of the facility is a net lease with [redacted] remaining obligated for all maintenance, improvement, taxes, insurance, repair and replacement of parts and nuclear decommissioning costs. The investors are not obligated to make an equity investment to fund any capital improvements in the property, but can leverage the cost of the improvements through additional notes.

The land on which the plant sits and the common facilities the unit shares with the adjacent [redacted] plant were excluded from the sale-leaseback transaction. [redacted] leased to the investors its share of the land for a [redacted] year period, which is equal to the lease term of the plant plus the time period from the end of the lease term to the license expiration date. The land is in turn sub-leased back to [redacted] for a period equal to the term of the facility lease. Nuclear fuel was similarly excluded from the transaction; [redacted] retained sole possession of the fuel and fuel assemblies. The investors have no rights to the possession or control of any nuclear fuel throughout the lease term.

The leases contain an option that [redacted] can repurchase the power plant at the end of the lease term for a fair market value sales price. Further, there are several circumstances under which the leases will terminate and either the lessee or the lessor can option to transfer the property and accompanying lessor obligations to [redacted]. These occurrences include a "Loss Event," in which reversion of the property occurs if the plant is incapacitated, destroyed, requisitioned or otherwise shutdown; and a "Deemed Loss Event," in which the investor similarly can terminate its involvement in the transaction. Threat of regulation as a utility, Nuclear Regulatory Commissioner (NRC) licensing, and potential liability for a nuclear incident are among the reasons the investors can "deem" a loss event has occurred. In either the loss or deemed loss situation, the investor is entitled to a casualty or special casualty payment that unconditionally returns a portion of the initial equity investment.

During the term of the lease, the investors' equity investment and net economic return is secured by letters of credit (LOCs) maintained by [redacted]. The initial letters of credit have a term of [redacted] years, ending in [redacted]. The LOCs provide for a maximum of $[redacted] to be drawn by the investors should [redacted] default on the lease payments. The investors' [redacted] percent equity in this transaction is approximately $[redacted]; the remaining $[redacted] secures the investors' net economic return during that period. [redacted] agrees to renew the LOCs throughout the lease to continuously secure the investors' equity. However, [redacted] may elect not to renew the LOCs which allows it to notify the investors of its intent to reacquire the facility, should the investors decide not to self-maintain the LOCs. The reacquisition price is fair market value or a casualty value, if higher.

Pursuant to written agreement, [redacted] has agreed to indemnify the investors' tax benefits throughout the transaction. If the sale-leaseback is challenged and determined not to be a lease, [redacted] agrees to pay the investors' economic return. [redacted] also agrees to indemnify the investors for any taxes resulting from the sale/disposition of the facility pursuant to a loss event, default, or other premature lease termination. The indemnity payments are to be made on an after-tax basis. If [redacted]'s tax indemnity payments exceed [redacted] percent of the present value of remaining lease payments (discounted at [redacted]%), [redacted] can opt to terminate the lease and reacquire the facility.

[redacted] may also terminate the lease prematurely if it determines that [redacted] is economically obsolete. In such event, [redacted] will arrange, if possible, for a third-party purchase of the plant, agreeing to guarantee the special casualty value to investors should the sales price fail to meet that amount. If no buyer is found, [redacted] would remain liable for the lease payments.

If [redacted] defaults on its lease payments, the investors can either terminate the lease, possess, sell or release the facility and/or demand a payment from [redacted]. The payment can be one of several amounts depending on the FMV of the plant, or its rental value. In lieu of this, the investors can demand an amount equal to casualty value, if higher. However, should [redacted] default on its payments, no demand is made on the lessor/investors to make payments on the lessor note. Further, the lessors/investors' equity investment is protected against default by the LOCs maintained by [redacted]. Failure of [redacted] to maintain or renew these LOCs without an accompanying notification of its intent to reacquire the facility will constitute an event of default.

[redacted] requested and received approval to enter the sale-leaseback transaction from the [redacted] ([redacted]) and the Nuclear Regulatory Commission (NRC).

DISCUSSION

In determining the propriety of sale-leaseback transactions, for advance letter ruling purposes, the Service has issued three revenue procedures: 75-21, 1975-1 C.B. 715; 75-28, 1975-1 C.B. 752; and 76-30, 1976-2 C.B. 647. Further, the Service's position for challenging such transactions as mere financing arrangements is set forth in Litigation Guideline Memorandum TL-15, "Litigation of Multi-Party Real Estate Sale-Leasebacks after Sanderson v. Commissioner, T.C. Memo. 1985-477." The primary focus under both the revenue procedures and the LGM is the distribution between the parties of the relative benefits and burdens of ownership. LGM TL-15 goes further to assess the economic substance and the business purpose of the transaction, disjunctively, in determining whether the transaction constitutes a true lease or is merely a financing arrangement.

Rev. Proc. 75-21

Rev. Proc. 75-21 provides general criteria that must be satisfied prior to Service issuance of an advance ruling regarding leveraged lease transactions. Although these guidelines do not define, as a matter of law, whether a transaction is a lease for Federal income tax purposes, compliance with them will be indicative of a valid lease. Upon satisfying the following conditions, the Service will consider the lessor in a leverage lease transaction to be the owner of the property and the transaction a valid lease:

(1) Minimum unconditional at risk investment;
(2) Lease term and renewal options;
(3) Purchase and sale rights;
(4) No investment by lessee;
(5) No lessee loans or guarantees; and
(6) Profit requirement

(1) Minimum Unconditional "At Risk" Investment of Lessor

This condition requires that the lessor:

a) make an initial minimum at risk investment of 20 percent of the cost of the property and that such investment be unconditional;

b) maintain this 20 percent minimum investment at all times throughout the entire lease term;

c) represent and demonstrate that an amount equal to at least 20 percent of the original cost of the property is a reasonable estimate of the property's fair market value at the end of the lease term; and

d) represent and demonstrate that a reasonable estimate of the remaining useful life of the property at the end of the lease term will be the longer of one year or 20 percent of the originally estimated useful life.

With regard to the 20 percent requirements, the lessor's initial equity investment in the present transaction equalled approximately [redacted] percent of the cost of [redacted]. In addition, section 8(f)(iv) of the lessor's Facility Lease purports that the 20 percent minimum investment will be maintained at all times during the lease term.

One of the key factors in determining whether a sale and leaseback transaction constitutes a valid lease is the reasonable expectation of residual value after the lease term. As aforementioned, the third and fourth prongs of the minimum investment guideline require the lessors to represent and demonstrate that at the end of the lease term the facility will have a residual value of at least 20 percent of its original cost. To meet this condition, the lessor/investors obtained an appraisal conducted by [redacted] which concluded that the facility could reasonably expect to have such residual value. Further, the appraisal estimated the remaining economic useful life of [redacted] to be at least [redacted] years. Since the term of the lease is [redacted] or [redacted] years, including the lessee's [redacted] years optional extension, the estimated remaining life of [redacted] will be at lease [redacted] years. Moreover, as a condition precedent to the lessors entering into this transaction, section 11(a)(27) of the parties' Participation Agreement stipulates that at the end of the base lease term, the lessors' interest in [redacted] will have an estimated residual value equal to at least [redacted] percent of the original cost. Further, section 12 of the Facility Lease provides as a condition to the lessee's exercise of its option to renew the lease for two additional years, that the lessee submit to the lessors an appraisal which indicates that the renewal term will not extend the lease term beyond 80 percent of the economic useful life of [redacted]. Based on this analysis, it appears that the minimum investment guideline has been satisfied.

(2) Lease Term and Renewal Options

In determining compliance with Rev. Proc. 75-21, the lease term must include all renewal or extension periods unless the rent for the renewal or extension term is specified to be the fair rental value at the time of renewal or extension. It is not certain whether the rent for the renewal term will equal the fair rental value of the property, however, the 2 year optional extension has been taken into account in determining compliance with Rev. Proc. 75-21.

(3) Purchase and Sale Rights

This guideline provides that no member of the lessee group may have a contractual right to purchase the property from the lessor at a price less than its fair market value at the time the right is exercised. In satisfaction of this requirement, Section 13(c) of the Facility Lease states that the lessee has the right to purchase the undivided interest on the date of the expiration of the lease term, for a price equal to its fair market sales value.

The guideline provides also that the lessor may not have a contractual right (except in certain limited circumstances) to cause any party to purchase the property. Moreover, the lessor must represent that it has no present intention to acquire such a right. Further, if such right is acquired in a subsequent period, the effect of such a right will be evaluated at such future time based on all the facts and circumstances. If the lessor is permitted to abandon the property to any party, such a provision will be treated as a contractual right to cause the party to purchase the property.

It is not apparent from a review of various transaction documents that the lessor had any specific contractual right to cause a purchase of the undivided interest by another party outside the occurrence of a "loss event" or a "deemed loss event", as described on page 3 of this memorandum.

(4) No Investment by Lessee

This guideline provides that no part of the cost of the property may be furnished by any member of the lessee group. Further, the lessee cannot finance any capital improvements to the property unless: 1) the lessee owns such improvements, and 2) the improvements are readily removable without causing material damage to the property.

It is not apparent from the various documents that the lessee has furnished any part of the cost of purchasing the lessor's undivided interest. However, the facts do indicate that [redacted] has financed significant improvements to [redacted] since the date of the sale-leaseback transaction.[1] It does not appear that these improvements are severable without causing material damage to [redacted]. Accordingly, Section 8(e) of the Facility Lease agreement provides that such improvements shall vest with the lessors. Based on this disclosure, it appears that the lessee has violated this guideline. However, the consequences of such a violation are not clear nor specified in Rev. Proc. 75-21 since the purpose of satisfying Rev. Proc. 75-21 is to obtain an advance letter ruling only.

(5) No lessee loans or guarantees

This guideline provides that no member of the lessee group may lend to the lessor any of the funds necessary to acquire the property or guarantee any indebtedness created in connection with the acquisition of the property by the lessor. The facts indicate that lessor notes were created to fund the debt portion of this sale-leaseback transaction. It is a question of fact to be decided by a court as to who would be liable for the notes in the event of a default. The notes are non-recourse as against the lessors, thus the issue is whether [redacted] or [redacted] would be liable.

Under the lease agreements, [redacted] is obligated to secure the payments of rents to the lessors during the lease period by means of obtaining and maintaining letters of credits. It is not clear however, whether the LOC would constitute a guarantee of indebtedness as contemplated under this guideline. The documents indicate that the only security for these notes is a lien on the undivided interest and an assignment of the Facility lease and

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[1] The technical assistance memorandum prepared by the ISP Utility Staff indicated that the improvements have totalled nearly $[redacted] and do not appear to be ordinary maintenance and repair expenditures. Conversely, [redacted] by letter dated [redacted], states that during [redacted] it financed $[redacted] of improvements to [redacted].

certain rights thereunder. Further, although [redacted] is required to make lease payments at least sufficient to pay the lessor's debt service, this guideline specifically provides that a guarantee by any member of the lessee group to pay rent, maintain the property, pay insurance or other conventional obligation of a net lease does not constitute a guarantee of the indebtedness of the lessor.

However, the facts raise a question as to the relationship between [redacted] and [redacted]. As indicated, [redacted] was formed to provide the long-term financing for the acquisition of [redacted]. Although apparently unaffiliated with any of the parties to the sale-leaseback transaction (i.e., no interest of [redacted] or the lessors own stock in or work for [redacted]), the Prospectus Supplement and the Underwriting Agreement disseminate information challenging such independence from [redacted]. The following observations were made:

> 1) [redacted] paid the costs of registering and issuing [redacted]'s securities, and will pay all expenses incident to the performance of its and [redacted]'s obligations under the agreement, including reimbursement of underwriters' expenses and payment of Investment Agency rating fees. Section 4(f) of the Underwriting Agreement
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> 2) The financial condition of [redacted] was imperative to the decision of underwriters to purchase the bonds and potential bondholders to invest. *See* Prospectus Supplement.
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> 3) [redacted] agrees to indemnify the underwriters against any claims arising from any inaccuracies of material fact in the offering material. *See* Section 8 of the Underwriting Agreement.
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> 4) [redacted] is thinly capitalized and thus, has no economic viability.[2]

Against this backdrop, it would be reasonable to link [redacted] to

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[2] [redacted] was formed solely for the purpose of providing third party financing. Its capital consists of $[redacted] in stock. It will never reflect a profit or loss on the transaction since its interest expense will always equal interest income due it from the lessor notes. Its assets consist only of pledged lessor notes, for which no recourse to the credit of the lessors exists should the lessee fail to make the lease payments.

[redacted], and thus indirectly liable for [redacted]'s obligations. As the ISP Utility staff properly pointed out, if it is determined that [redacted] is essentially a conduit under the control of the lessee, then this sale-leaseback transaction would resemble the two-party sale-leaseback transaction overturned in Helvering v. Lazarus and Co. 308 U.S. 252 (1939).

(6) Profit Requirement

This guideline mandates that the lessor represent and demonstrate that it expects to receive a profit from the transaction, exclusive of tax benefits. This requirement is met if the lessor shows that 1) the sum of the aggregate rents plus the residual value exceed the sum of the lessor's aggregate costs and equity investment and 2) a reasonable positive cash flow exists. Based on the ISP Utility Staff's calculations, it appears that this requirement will be met.

In summary, with the possible exceptions of items (4) no investment by lessee and (5) no lessee loans or guarantees, it appears that [redacted] would satisfy Rev. Proc. 75-21 for obtaining an advance letter ruling regarding the legitimacy of the transaction. Since satisfaction of Rev. Proc. 75-21 is not conclusive evidence of a proper sale-leaseback arrangement, the next step is to assess the case law in this area, with particular focus on where the burdens and benefits of ownership fall.

Burdens and Benefits of Ownership

Litigation Guideline Memorandum TL-15 entitled "Litigation of Multi-Party Real Estate Sale-Leasebacks after Sanderson v. Commissioner, T.C. Memo. 1985-477," provides that the existence of a valid sale is a prerequisite to finding a valid sale-leaseback, thus inquiry should be made concerning whether the purported buyer acquired the burdens and benefits of ownership. In determining where the burdens and benefits of ownership fall, LGM TL-15 also points out that with the Tax Court's recognition of the widespread use of net leases and nonrecourse financing in the real estate industry and acceptance of structuring "rental" payments to equal principal and interest amounts as neutral factors, the burdens and benefits argument has been easily satisfied in most commercial real estate deals. Thus, a determination of whether the transaction at hand is in fact a valid sale-leaseback arrangement will turn on its comparison to the present case law in this area.

One of the leading sale-leaseback cases is Frank Lyon Co. v. United States, 435 U.S. 561 (1978). In this case, a bank entered into a sale-leaseback agreement with petitioner Frank Lyon, who took title to the building and leased it back to the bank for long-term use. The petitioner obtained both a construction loan and permanent mortgage financing. The bank agreed to pay rent equal to the principal and interest payments on petitioner's mortgage and had an option to repurchase the building at various times at prices equal to the then unpaid balance of petitioner's mortgage and initial $500,000 investment. The Service sought to disallow the lessor's deductions for depreciation and interest on the ground that petitioner was not the owner of the building for tax purposes but that the sale-leaseback arrangement was a financing transaction in which petitioner loaned the bank $500,000 and acted as a conduit for the transmission of principal and interest to petitioner's mortgage. The district court held that the claimed deductions were allowable, but the Court of Appeals for the Eighth Circuit reversed, agreeing with the Commissioner. In reversing the Court of Appeals, the Supreme Court found that the sale-leaseback transaction was not a sham by which petitioner was just a conduit used to forward the mortgage payments made under the guise of rent paid by the bank to petitioner, on to the mortgagee. The construction loan and mortgage note obligations on which petitioner paid interest were his obligations alone, and thus entitled him to the claimed deductions. 435 U.S. at 580-581. The Court held further that:

> [W]here . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties . . . .

Id.

The Tax Court has interpreted this language to mean that, to uphold the validity of a sale-leaseback transaction, the transaction must either satisfy a subjective "business purpose" test, or satisfy an objective "economic substance" test. Estate of Thomas v. Commissioner, 84 T.C. 412, 438-439 (1985); Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 201-203 n. 17 (1983), aff'd, in part and rev'd in part on other grounds, 752 F.2d 89 (4th Cir. 1985). The business purpose test focuses upon the motives of the taxpayer for entering into the transaction, and the economic substance test involves an analysis of whether the transaction had a reasonable possibility of profit apart from tax benefits. Whether a particular transaction is a sham under this analysis is a question of fact. Rice's Toyota World, Inc. v. Commissioner, 752 F.2d at 92, 94.

In the case at hand, there is little doubt that tax benefits were a significant consideration for entering the sale-leaseback arrangement. However, the facts indicate also that the investment in [redacted] provides a realistic opportunity for economic profit apart from tax benefits. Based on the ISP Utility Staff Calculations (Exhibit C), the terms of the Facility Lease, and the provisions to revise the rent schedules if additional costs are incurred, arguing that the investors could not have reasonably relied on the prospect of realizing a reasonable economic profit on its investment is unlikely to prevail.

In applying this economic substance test, the Tax Court has established two subparts for this test; cash flow and future appreciation. See Hilton v. Commissioner, 74 T.C. 305 (1980), aff'd, 671 F.2d 316 (9th Cir. 1982); Dunlap v. Commissioner, 74 T.C. 1377 (1980), rev'd on other grounds, 670 F.2d 785 (8th Cir. 1982); and West v. Commissioner, T.C. Memo. 1984-421. With regard to the cash flow sub-test, minimal or nonexistent cash flow during the initial term but substantial return during renewal periods will be acceptable. See West, T.C. Memo. 1984-421; and Dunlap, 74 T.C. 1377. Based on the calculations made, it is clear that the transaction will yield sufficient cash flow before and after taxes to satisfy the cash flow sub-test. It is projected that the rate of return over the full lease period will average approximately [redacted] percent. Moreover, although minimal, the projected cash flow through the year 2002 will average less than two percent.

With respect to the appreciation sub-test, the facts indicate that at the end of the lease period, including any extensions, [redacted], will have a remaining useful life of at least [redacted] years. Any appreciation of this facility will vest with the lessor/investor. The prospect for appreciation in the value of [redacted] is great considering that [redacted] has made between $[redacted] and $[redacted] of improvements to [redacted] which are not severable without causing material damage.

In summary, it appears that the sale-leaseback transaction in the present case would satisfy the economic substance test articulated in Frank Lyon Co. v. United States, supra. Our analysis reveals positive cash flow, a substantial prospect of appreciation, and that sole right to the appreciation vested in the lessors/investors. Thus, attacking this transaction as a mere financing arrangement is unlikely to be productive. However, it is not likely that [redacted] would rely on Frank Lyon in boasting the legitimacy of this transaction since one of the key factors of Frank Lyon, not present here, is the fact that the buyer/lessor alone was liable for the debt if the lessee failed to make the lease payment. In the present case, the debt is non-recourse to the credit of the lessors.

As mentioned at the beginning of this section, the existence of nonrecourse financing is to be treated as a neutral factor in assessing the propriety of a sale-leaseback transaction. In fact, case law has upheld sale-leaseback arrangements where the debt financing the purchase was non-recourse. See Dunlap v. Commissioner, 74 T.C. 1377 (1980), rev'd on another issue, 670 F.2d 785 (8th Cir. 1982); and Sanderson v. Commissioner, T.C. Memo. 1985-477.

In Dunlap, Safeway Stores, Inc. built a warehouse and conveyed its interest in the property to El Paso Properties, Corp. ("El Paso") for $8,800,000. El Paso was a single-purpose financing corporation that was formed to acquire title to the property, to secure financing of the purchase price of the property, to arrange a leaseback of the property to Safeway, to transfer title of the property to Safeway, and to transfer title of the property and the lease agreements to individual investors.

Eight individual investors, including the taxpayer, raised $387,000 of the purchase price with El Paso placing $8,413,000 of secured notes with various institutional investors. The individual investors were not liable on the secured notes. The notes were secured, in part, by an indenture of mortgage and a deed of trust that required all payments of rent under the lease to be made directly to the trust. The annual rental payments were calculated to provide the individual investors with money sufficient to meet the payments of principal, interest, and yearly management fees for the initial 25-year term of the lease.

The Tax Court found the sale-leaseback transaction to be valid, thus permitting the taxpayer's claimed depreciation and interest deductions for his share of the property. The court disagreed with the Service's position that the investment was purely tax motivated or that it presented no realistic opportunity for economic (nontax) gain. Dunlap, supra at 1437.

In Sanderson, T.C. Memo. 1985-477, a J.C. Penney store was sold and simultaneously leased back from the buyer pursuant to a long-term net lease. The total purchase price for the buildings was $6,060,000, which was financed by $127,260 in cash and two mortgage loans totaling $5,932,740. The promissory notes that represented the two mortgage loans were nonrecourse and were secured by the property. The Tax Court held that the transaction did not lack economic substance, thus constituting a valid sale-leaseback. Consequently, the buyer-lessor petitioners were entitled to interest and depreciation deductions.

The sale-leaseback arrangements in Dunlap and Sanderson are very analogous to the present transaction. Although the amount of the deductions in the present case is much larger than in Dunlap and Sanderson, it is unlikely that the Tax Court will reverse its position on these cases.

Once again, the ISP Utility Staff have properly recognized that the lessors/investors have no burdens of ownership with regard to the operation of [redacted]. Pursuant to the [redacted] operating agreement, [redacted] is responsible for all maintenance and decommissioning costs, and is the lawful representative for all questions before any regulatory agency concerning Unit 2 operational matters. Further, the Nuclear Regulatory Commission ("NRC") license does not permit the investors to possess or exercise any control over the operation of the plant during the terms of the lease and license. However, in our opinion, these facts alone are not sufficient to characterize the present sale-leaseback transaction as similar to the one held to be a financing arrangement in Illinois Power Co. v. Commissioner, 87 T.C. 1417 (1986), AOD CC-1990-04 (February 5, 1990). In fact, in Illinois Power Co., it was the taxpayer who sought and provided evidence sufficient to disavow the form of the transaction as a sale-leaseback.

In Illinois Power Co., the petitioner owned an 80-percent undivided interest in a nuclear power plant under construction. Through the form of a sale-leaseback transaction, the petitioner sought to finance the nuclear fuel supplied to the plant. In pursuit of this objective, petitioner formed Illinois Power Fuel Co. ("IPFC"), with all 100,000 of its shares being issued to petitioner. All of the officers and directors of IPFC were also officers of petitioner. IPFC had no employees. In accordance with the application filed with the Federal Energy Regulatory Commission, petitioner donated 50 percent of its equity interest to a tax exempt charitable institution. Petitioner represented also that it would sell nuclear fuel to IPFC, lease the fuel back from IPFC, and enter into a "Cash Deficiency Agreement", under which the petitioner obligated itself to make loans to IPFC at any time the obligations of IPFC which were due exceeded the funds available to IPFC. Petitioner was also obligated to maintain bank lines of credit to support its own and IPFC's commercial paper.

Pursuant to the nuclear fuel lease agreement between IPFC and petitioner, petitioner promised to pay all of borrowing costs or other costs incurred by IPFC in acquiring the fuel. The term of the lease was 40 years. The expected life of the nuclear fuel was approximately 3 to 4 years. Once loaded into the reactor, the nuclear fuel could not be used elsewhere and had no residual value.

In holding for the petitioner, the Tax Court concluded that the sale-leaseback transaction at issue was a financing arrangement for purposes of the Federal tax laws. Illinois Power Co., 87 T.C. at 1442. The court was convinced that the petitioner had presented strong proof to disavow the form of the sale-leaseback transaction. Such proof consisted of the fact that the petitioner itself treated the sale-leaseback as a financing arrangement for tax reporting and other purposes. In the IPFC's corporate tax return for 1981, it was stated that the petitioner entered into the sale-leaseback transaction "to effect a financing arrangement for its nuclear fuel." Id. at 1433. Further indicia that petitioner had retained the benefits and burdens of ownership of the nuclear fuel included:

- No effort made by the petitioner to sell the fuel to IPFC at its fair market value. Accordingly, the purchase price paid by IPFC for the nuclear fuel represented the value of the fuel as shown on the petitioner's books. Id. at 1435-1436.

- Under the lease agreement, petitioner was required to pay IPFC an amount sufficient to cover:

  (1) all of IPFC's costs to issue and pay interest on the outstanding commercial paper;

  (2) any administrative costs incurred by IFPC; and

  (3) the amounts initially paid by IPFC to acquire the nuclear fuel. Id. at 1436.

- The nuclear fuel had an estimated useful life of only 3 to 4 years; the use rights associated therewith remained exclusively with petitioner, not IPFC. Id. at 1437.

- Petitioner was designated under the lease as the lawful representative of IPFC in all dealings with manufacturers and any regulatory agency having jurisdiction over the ownership or possession of the nuclear fuel. Id. at 1439.

- Petitioner was given the right to purchase all or any portion of the nuclear fuel from IPFC at any time throughout the lease term, regardless of the fair market value of the fuel. Id. at 1439.

As aforementioned, some of the factors used in finding a financing arrangement in Illinois Power Co. are present in the case at hand. However, several facts clearly distinguish this case from Illinois Power Co. First is the ostensibly independent relationship of the parties. Here, the affiliation between [redacted] and the lessors/investors is unclear. Although [redacted] has paid the underwriting and other fees incident to the issuance of bonds by [redacted], no employees or directors of [redacted] are employees of [redacted], unlike the situation in Illinois Power Co. Second, per the various agreements, it appears that the transaction was consummated via an arm's-length bargaining process. The lease at hand contains an option that allows [redacted] to repurchase the power plant at the end of the lease term for its fair market value. Third, and most importantly, a useful life of [redacted] years or more will remain after the lease term, inclusive of any extension periods, thus enhancing the possiblity of a remaining residual value. In Illinois Power Co., the lease term far exceeded the useful life of the nuclear fuel. Thus, no residual value remained.

Further, the regulatory requirements to be satisfied by the lessors/investors before regaining [redacted] after the lease term can be satisfied. [redacted] notes that the possible future purchasers of [redacted] would likely include any of the current [redacted] participants, who are:

[redacted]

Moreover, other electric utility companies or agencies, such as the [redacted], [redacted], and [redacted] exist in the area and are therefore potential purchasers.

Based on a review of the present case, in light of the present case law, as well as the revenue procedures, we believe that a challenge to the sale-leaseback transaction would not be productive and the Service would not prevail. As mentioned above, the present case law regarding sale-leaseback transactions of this kind would not be in our favor. Here, fair market value sales price has been bargained for. Further, the prospect of economic profit and a substantial remaining residual value after the expiration of the lease is great. Consequently, the Tax Court would probably respect whatever label [redacted] places on this transaction.

In summary, we applaud the effort by the ISP Utility Staff in recognizing the potential abuse in the use of sale-leaseback transactions. However, based on our analysis of the facts of the instant case and the case law in this area, it is our opinion that such transaction can not be successfully challenged as a mere financing arrangement.

If you have any further inquires regarding this matter, please contact James A. Wright at FTS 566-3521.

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
Branch No.1
Tax Litigation Division